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No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF FOR AMALGAMATED BANK, AS TRUSTEE FOR THE LONGVIEW COLLECTIVE INVESTMENT FUND, CHANGE TO WIN, AND THE CtW INVESTMENT GROUP AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF *AMICI*[1]

Amalgamated Bank is America's oldest labor-owned bank. Its $7 billion LongView Collective Investment Fund invests assets in the American securities market, mostly for the benefit of pension fund beneficiaries. Change to Win is an

[1] This brief was not authored, in whole or in part, by counsel for either party, and no person or entity other than *amici*, their members and their counsel made a monetary contribution to the preparation or submission of this brief. The parties' general letters of consent to the filing of this and other *amicus* briefs have been filed with the clerk.

alliance of seven partner unions and six million workers, united to build a new movement of working people that can meet the challenges of the global economy and restore the American Dream: a paycheck that can support a family, affordable health care, a secure retirement, and dignity on the job.[2] The CtW Investment Group, which is affiliated with Change to Win, was established in February 2006 to protect the retirement security of Change to Win workers who participate in Taft-Hartley and public pension funds with approximately $1.5 trillion in assets. Because these funds are responsible for supporting the retirement benefits of their participants, they are diversified, are focused on long-term appreciation, and are particularly concerned with corporate governance issues, including the prevention of securities fraud, as a means of achieving reliable long-term results. In short, these *amici* are the paradigmatic "institutional investors" to whom Congress entrusted the presumptive leadership of private securities litigation.

Given the foregoing, the *amici* are concerned that appropriate litigation remains a strong factor to ensure corporate responsibility. They have a significant interest in assuring that the remedies granted fiduciary investors are not impaired by unreasonably high scienter pleading standards, or draconian and discriminatory dismissal procedures that will make it impossible for them to pursue meritorious claims.

SUMMARY OF ARGUMENT

As a threshold matter, *amici* here are in complete agreement with an overriding point treated fully elsewhere: That with Section 21D(b) of the Private Securities Litigation

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[2] The seven partner unions are: International Brotherhood of Teamsters, Laborers' International Union of North America, Service Employees International Union, UNITE HERE, United Brotherhood of Carpenters and Joiners of America, United Farm Workers of America, and United Food and Commercial Workers International Union.

Reform Act of 1995 ("Reform Act"),[3] Congress crafted a uniform pleading regime for §10(b) cases by adopting the Second Circuit's "strong inference of scienter" pleading test—the then-most-stringent standard. *Novak v. Kasaks*, 216 F.3d 300, 310 (2d Cir. 2000). That "strong inference" standard accepted well-pleaded facts as true and gave plaintiffs the benefit of reasonable inferences to determine if they "*may be able to prove* that defendants *more likely than not knew* that their . . . representations were false." *Cohen v. Koenig*, 25 F.3d 1168, 1174 (2d Cir. 1994).[4] That stringent standard never required, however, the consideration of "competing inferences" or defendants' "non-culpable explanations," or that the pleadings establish a "high likelihood" of scienter. Rather, courts still "accept as true the facts alleged in the complaint" (*Chill v. Gen. Elec. Co.*, 101 F.3d 263, 267 (2d Cir. 1996)), and "draw all inferences in favor of the pleader." *Cosmas v. Hassett*, 886 F.2d 8, 11 (2d Cir. 1989).[5] *Amici* here will not belabor the point beyond stating our agreement with it. *See* S. Ct. Rule 37.1.

This particular brief discusses, instead, (a) the myriad evidence contradicting Petitioners' arguments that securities fraud defendants deserve even *more* protection from private actions, (b) the lack of deference accorded the Securities and Exchange Commission's ("SEC") contradictory turnaround from its recent *amicus* position in numerous other post-Reform Act cases, and (c) the serious consequences at stake for America's investors.

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[3] Pub. L. No. 104-67, 109 Stat. 737 (1995).

[4] Emphasis added throughout and citations omitted, unless otherwise indicated.

[5] It is logical that Congress looked to the Second Circuit for guidance. *SEC v. Kasser*, 548 F.2d 109, 115 (3d Cir. 1977) (Second Circuit has special expertise in securities law); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 762 (1975) (Blackmun, J., dissenting) (Second Circuit is "the 'Mother Court' in [the securities] area").

Petitioners and their *amici* seek discriminatory pleading and radically liberalized dismissal rules that they claim are embedded in the "strong inference" pleading language of the Reform Act. In so doing, they demean the value of private enforcement of the securities laws—whether on a class or individual basis.[6] The present submission shows that the interpretations that Petitioners and their *amici* urge were never adopted by Congress, and empirically demonstrates the continuing importance of private securities suits, as well as the absence of data indicating that those suits are excessive or are being abused.

Among Petitioners' *amici*, the SEC's position is particularly disappointing—for the new position is patently inconsistent with that agency's mission to protect investors. The SEC contradicts its long-standing acknowledgement that private suits provide a valuable supplement to its limited enforcement resources, as well as the importance of those suits in policing the markets and compensating investors. Indeed, the SEC's new position contradicts its stance in at least ten prior *amicus* submissions concerning the Reform Act—namely that the Reform Act adopted the Second Circuit's "strong inference" of scienter pleading standard. *See* Appendix hereto at 1a-3a (compiling examples of SEC's recent *amicus* language concerning the "strong inference" standard). Such a newfound contradictory position—especially in *private* actions in which the SEC lacks practical experience—warrants no deference.

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[6] While Petitioners and their *amici* imply that these radically different dismissal standards would apply only to class actions, in fact the language they rely on applies to "*any private action.*" 15 U.S.C. §78u-4(a)(2)(A)(ii). In other words, at risk here is effective private enforcement *across the board.*

Seldom has an *amicus* position taken by the SEC attracted such widespread public criticism. A recent article in *The New York Times* crystallized the criticism:

> [T]he commission filed a little-noticed brief in the Supreme Court *urging the adoption of a legal standard that would make it harder for shareholders to prevail in fraud lawsuits* against publicly traded companies and their executives.
>
> * * *
>
> Critics said that the moves signaled a major retrenchment from the post-Enron changes . . . . "It is clear from these actions that this is a commission intent on reversing seven decades of rule making, by Democrats and Republicans, that have protected investors . . . ." said Lynn E. Turner, a former chief accountant at the commission . . . .
>
> * * *
>
> "After reading the brief, one has to wonder if the S.E.C. is now on the side of the defense bar," said Professor Fisch . . . . "*This does not read like an S.E.C. brief since it does not articulate anything about the commission's experience in the area. It reads, instead, like a litigant's brief.*"

Stephen Labaton, *S.E.C. Seeks to Curtail Investor Suits*, N.Y. Times, Feb. 13, 2007, at C1.[7]

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[7] *See also SEC Brief Favors Limiting Investor Suits*, Associated Press, Feb. 13, 2007 ("Barbara Roper, director of investor protection for Consumer Federation of America, called the agency's filing of the brief 'a very troubling sign that the SEC may be increasingly looking to intervene in these cases to restrict the rights of investors.'"); Jonathan Peterson, *Critics Fear SEC Chief Is Seeking To Limit Investors' Ability To Sue*, Los Angeles Times, Feb. 20, 2007, at C1 ("some observers feared the SEC was playing favorites, taking the side of corporate managers"); Gretchen Morgenson, *S.E.C. Facing Wide Review of Practices*, N.Y. Times, Oct. 27, 2006, at C1 (Chairman of the Senate Finance Committee "asked

At bottom, Congress designed the Reform Act's heightened pleading standard to create uniformity—and yet Congress's objective continues to be frustrated.[8] This situation would be *worsened* by the conflicting results that would flow from pleading-stage consideration of "innocent inferences" and "non-culpable explanations," *i.e.*, defendants' favorable spin and factual denials. Worse, interpreting "strong" to mean "high likelihood" would require plaintiffs to *plead* facts beyond the "more likely than not" preponderance-of-the-evidence *proof* standard (*see Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 (1983)), violating the right to a jury trial. If judges must weigh "non-culpable explanations" and "innocent inferences," assertions not subject to Rule 11 will enter the dismissal equation. Such assertions cannot be reliably weighed at the pleading stage and no objective standards exist to determine their veracity. Precedents will become confused and outcomes less predictable—a result that this Court rejects.[9]

[GAO] to conduct a review of the commission because he was growing concerned . . . about whether it is 'faithfully adhering to its mission'"); Edward Siedle, *The Irrelevant SEC—In Bed With the Industry It's Supposed to Regulate, It Needs a Shake-Up*, Forbes, Nov. 27, 2006 ("[T]he federal agency charged with safeguarding investors is on the verge of becoming irrelevant. If you want protection from investment pitfalls, you're going to get it from the private sector.").

[8] *See, e.g., Helwig v. Vencor, Inc.*, 251 F.3d 540, 549 (6th Cir. 2001) (en banc) ("the aftermath of the PSLRA has been anything but uniform as courts attempt to divine how much of the Second Circuit standard Congress intended to incorporate"), *cert. dismissed*, 536 U.S. 935 (2002); Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?* 2003 U. Ill. L. Rev. 913, 926 (2003) ("It is clear that Congress did not achieve one stated goal with respect to the pleading standard—ending the pre-PSLRA circuit split over the pleading requirements in securities fraud cases. Courts have split sharply over precisely what the "strong inference" portion of the standard requires.").

[9] *See Cent. Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164, 188-91 (1994) (rejecting aiding and abetting liability as "the rules for determining [it] *are unclear*, in 'an area that demands *certainty and*

This Court should achieve uniformity by ruling that the Reform Act adopted the Second Circuit's "strong inference" scienter pleading standard, and remand for a determination of whether the complaint in issue satisfies that standard.

ARGUMENT

I. PRIVATE ENFORCEMENT SUITS PLAY AN IMPORTANT ROLE IN POLICING OUR MARKETS AND COMPENSATING INVESTORS; THEY ARE NOT BEING ABUSED OR HARMING CORPORATIONS, BANKS, ACCOUNTING FIRMS OR OUR MARKETS

Although the SEC has primary authority for enforcing §10(b) of the 1934 Act, this Court, Congress, and the SEC have long supported private suits under §10(b). This Court has called such complementary suits "a most effective weapon in the enforcement" of securities laws (*J. I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)), a "necessary supplement to Commission action" (*id.*), and "an essential tool for enforcement of the 1934 Act's requirements." *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988).[10]

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predictability,'" and it would lead to "the undesirable result of decisions '*made on an ad hoc basis, offering little predictive value*'").

[10] *See also Blue Chip*, 421 U.S. at 729-30; *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985); *Randall v. Loftsgaarden*, 478 U.S. 647, 664 (1986). Petitioners and their *amici* seek a crabbed, anti-remedial interpretation of the 1934 Act, despite this Court's repeated admonition that §10(b) be interpreted *flexibly* to facilitate its remedial purposes. *See SEC v. Zandford*, 535 U.S. 813, 819 (2002) (unanimous opinion explaining "statute should be 'construed "not technically and restrictively, but flexibly to effectuate its remedial purposes"'") (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972)); *see also Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) (unanimous opinion stating that §10(b) "must be read flexibly, not technically and restrictively").

While the Congressional Conference Committee considering the Reform Act was clearly concerned with perceived abuses of §10(b) suits, that Committee's report nonetheless recognized that such suits were "an indispensable tool" for defrauded investors to recover without having to rely on government action, and noted that they "promote public and global confidence in our capital markets and help to deter wrongdoing."[11] The liberalized dismissal standard now urged upon the Court by Petitioners and their *amici* would undermine Congress's effort—reflected in its comprehensive review and revision of private securities suits—to emphasize vigorous private enforcement while barring meritless claims.

The SEC also has repeatedly praised private §10(b) suits as a supplement to Commission enforcement authority. As recently as 2003 the SEC noted that:

> Private litigation . . . offers the dual benefit of complementing Commission enforcement action and providing a mechanism to compensate investors through the award of restitution or damages. . . . The ability of investors to fully recover their losses, indeed, may largely depend on the use of private actions. Further, courts have recognized that the *Commission's limited resources may oblige it to prosecute only the most "flagrant abuses*," and that private actions complement Commission enforcement action and allow for the fullest investor recovery.[12]

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[11] H.R. Conf. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 730.

[12] SEC, Report Pursuant to Section 308(c) of the Sarbanes-Oxley Act of 2002, at 19-20 (Jan. 24, 2003), http://www.sec.gov/news/studies/sox308creport.pdf; *see also* 58 S.E.C. Docket 697-322 (Dec. 15, 1994) ("The Commission has consistently stressed the importance of and supported private rights of action under the antifraud provisions of the securities laws."); Testimony of Arthur Levitt, U.S. Securities and Exchange Commission, *Concerning Litigation Reform Proposals Before the Subcommittee on Telecommunication and Finance Committee on Com-*

Given the Commission's limited resources, it came as no surprise when a recent study found that the SEC detected *only 6%* of reported cases of corporate fraud at large companies between 1996 and 2004.[13]

Petitioners' proposal would enable dishonest actors to win dismissals on the pleadings by proffering speculative and unfounded claims that remain immune from the acid tests of sanctions, discovery, and the perjury laws. Such a result would conflict with this Court's precedents "[making] it clear that rules facilitating §10(b) litigation 'support the congressional policy embodied in the 1934 Act' of combating all forms of securities fraud." *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 376 (1991) (Kennedy, J., dissenting) (citing *Basic*, 485 U.S. at 245.) The entire investing public would be harmed.

Nor should the Court be swayed by arguments that "speculative" or "frivolous" §10(b) suits abound. Numerous Reform Act provisions already make it significantly more difficult to plead §10(b) cases. To wit: each alleged misstatement's falsity must be specifically pleaded, specific facts must be pleaded to raise a strong inference of each defendant's scienter, and all facts supporting plaintiff's information and belief must be pleaded. 15 U.S.C. §78u-4(b)(1)(B). As a result, many valid suits are dismissed every year; indeed, securities fraud cases at HealthSouth, Tyco, and WorldCom, filed in October 1998, December 1999, and November 2000 when those frauds were ongoing, were nonetheless dismissed

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merce (Feb. 10, 1995), http://www.sec.gov/news/testimony/testarchive/1995/spch025.txt ("Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws.").

[13] Alexander Dyck, Adair Morse & Luigi Zingales, *Who Blows The Whistle On Corporate Fraud?*, U.C. Berkeley Law and Economics Workshop, Apr. 10, 2007.

for failure to meet the heightened Reform Act pleading standard.[14] Later, these frauds burst open and the CEOs involved were ousted and indicted and new complaints were filed. But the fact that the early cases—which pleaded the frauds that were then occurring—were dismissed under the Reform Act's pleading standard is a cautionary tale as to the need for a pleading standard that does not ignore "*practicalities of litigation*" or "*tip[] the scale too far in favor of the wrongdoers*." *Lampf*, 501 U.S. at 374, 377, 379.

The Reform Act also imposed a *mandatory* discovery stay so long as *any* motion to dismiss is pending, 15 U.S.C. §78u-4(b)(3)(B), making it impossible for a securities fraud plaintiff to obtain discovery to create a case, and creating powerful disincentives for a plaintiff to file a flimsy complaint in an effort to inflict expense and extract a settlement. The Reform Act even requires a judicial sanctions review at the end of every dismissed case, and mandates the imposition of sanctions (presumed to be the entire cost of defense) for any frivolous allegation in a dismissed complaint. 15 U.S.C. §78u-4(c)(1). Protection against frivolous suits does not require a pleading bar so high that meritorious claims are blocked.

If anything, private enforcement should be enhanced at this point. The list of household corporate names caught up in post-Reform Act scandals is dizzying: Enron, WorldCom, Adelphia, Global Crossing, Tyco, Computer Associates, HealthSouth, Qwest, Freddie Mac, Dynegy, Fannie Mae, Royal Ahold, Nortel, Hollinger, Parmalat, Refco, AOL Time Warner, and Tenet are only the most prominent. Nor were public corporation executives the only wrongdoers. Wall Street analysts were corrupt often enough for Congress to

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[14] *In re Tyco Int'l, Ltd. Sec. Litig.*, 185 F. Supp. 2d 102, 109 (D.N.H. 2002); *Goldstein v. MCI Worldcom*, 340 F.3d 238, 243 (5th Cir. 2003). In *In re Healthsouth Corp. Sec. Litig.*, No. CV 98-J-2634-S, 2000 U.S. Dist. LEXIS 20650 (N.D. Ala. Sept. 13, 2000), a magistrate-judge recommended dismissal.

take action to erect *real* "Chinese Walls" between sell-side analysts and investment banking divisions of major financial firms. Banks were implicated in the Enron, WorldCom, and HealthSouth frauds. Mutual funds were beset with illegal practices such as "market timing," and many NYSE specialists cheated by "pennying," "front-running" and "interpositioning."

The shock waves from the post-Reform Act frauds continue to reverberate. In 2000, the SEC's former Chief Accountant publicly noted that over 75% of corporate CFOs had admitted to being asked by their CEOs to misstate earnings—*and that 40% had complied!*[15] Since 2001, at least 5,000 companies have restated their earnings—an admission, under Accounting Principles Board ("APB") Opinion No. 20, that those statements were false when published[16]—and major corporations, including Dell, General Motors, and Apple, *still* find themselves unable to issue current financial statements.

More recently, over 120 major public corporations have come under scrutiny for allegedly backdating stock options granted to executives and/or directors prior to Sarbanes-Oxley's passage in 2002.[17] That number may represent only the tip of the iceberg; a prominent study led by Harvard Law professor Lucian Bebchuk found that wholly 12% of sample

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[15] Speech by Lynn Turner, SEC Chief Accountant, *Executive Ethics Forum: Today's Ethics Yield Tomorrow's Behavior* (Sept. 29, 2000).

[16] David Reilly, *Restatements Still Bedevil Firms—Overall Total Hits a Record as Big Companies Improve*, Wall St. J., Feb. 12, 2007, at C7; *see generally* APB Opinion No. 20.

[17] *The Wall Street Journal* maintains an "Options Scorecard" at www.wsj.com. As of March 4, 2007, it listed over 120 companies that had disclosed either government probes, misdated options, restatements and/or executive departures.

firms had provided at least one stock-option grant whose timing was the result of manipulation from 1996-2005.[18]

As leveraged buyouts and management-led buyouts have returned to Wall Street, so has insider trading. The SEC just unveiled charges in what it called a "brazen" scheme whereby several blue-chip investment firms sent insider tips to major hedge funds,[19] and an independent study commissioned by *The New York Times* found that 41% of companies receiving buyout bids during a recent 12-month period "exhibited *abnormal and suspicious trading* in the days and weeks *before those deals became public.*"[20] Financial fraud and malfeasance remain powerful threats to investors.

In contrast, there is no evidence that private enforcement of our securities laws is hurting our nation's markets or its economy. In 2006, while both Wall Street profits[21] and merger-and-acquisition activity[22] hit record highs, new filings of securities class action suits *continued to decline*. According to a recent study by NERA Economic Consulting, cal-

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[18] Lucian Bebchuk, Yaniv Grinstein & Urs Peyer, *Lucky CEOs*, Harvard Law School and NBER (Nov. 16, 2006), http://www.issproxy.com/pdf/LuckyCEOs_Bebchuk-Grinstein-Peyer.pdf. Bebchuk, *et al.*'s sample included "all the at-the-money, unscheduled grants awarded to public companies' CEOs during the decade of 1996-2005." *Id.* at 2.

[19] Randall Smith, Kara Scannell & Paul Davies, *A 'Brazen' Insider Scheme Revealed*, Wall St. J., Mar. 2, 2007, at C1.

[20] Gretchen Morgenson, *Whispers of Mergers Set Off Bouts of Suspicious Trading*, N.Y. Times, Aug. 27, 2006, at 1.

[21] Ben White & David Wighton, *Wall Street Banks Report Record Earnings*, FT.com, Dec. 14, 2006.

[22] Peter Thal Larsen, *Takeovers Reach a Record High*, Financial Times, Jan. 25, 2007; Dennis K. Berman, *How to Assess 2007's M&A Activity*, Wall St. J. Online, Jan. 16, 2007, at C1; Dennis K. Berman, *Year-End Review of Markets & Finance 2006—Can M&A's 'Best of Times' Get Better?—Private Equity Fuels a Frenzy of Deals*, Wall St. J., Jan. 2, 2007, at R5.

endar year 2006 saw just 135 companies sued out of over 20,000 public companies, mutual funds and investment vehicles susceptible to §10(b) suits—"a 36% drop from 2005 levels, and a 44% decline from the post-PSLRA average."[23] NERA also found that "[d]ismissal *rates have nearly doubled* since [the passage of the] PSLRA," with more than 38% of class actions filed between 1999 and 2004 ending in dismissal.[24] As one prominent investor advocate noted in reaction to the SEC's *amicus* brief in this case, "'[w]ith the number of securities class actions falling, it's hard to see a compelling need to raise the bar.'"[25]

Nor do recent headline-grabbing, multi-billion-dollar settle ments suggest this Court's intervention is necessary to stop "meritless" §10(b) suits. A recent study by PricewaterhouseCoopers pointed to "the severity of some of the corporate accounting scandals and alleged financial frauds"

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[23] Todd Foster, Dr. Ronald I. Miller & Dr. Stephanie Plancich, *Recent Trends in Shareholder Class Action Litigation: Filings Plummet, Settlements Soar*, NERA, Economic Consulting (Jan. 2, 2007), http://www.nera.com/Publication.asp?p_ID=3028 ("NERA 2006 Study"); *see Distribution of Publicly Traded Companies, by Listing Venue* (Apr. 23, 2006), http://www.sec.gov/ info/smallbus/acspc/appendj.pdf; *Number of Investment Companies*, Investment Company Fact Book (2006), http:\\www.icifactbook.org/data/06_fb_Sec1_chart.2xls.

[24] NERA 2006 Study; *see also Securities Class Action Case Filings – 2006: A Year in Review*, Cornerstone Research (2007), http://securities.Cornerstone.com/pdfs/ YIR2006.pdf ("Class action securities fraud filings, plunged to a record low in 2006 . . . 110 . . . the smallest number of filings in a calendar year since the adoption of the [95 Act]. Filings are down by 38 percent from the 178 filed in 2005 and are 43 percent lower than the ten-year historical average of 193.").

[25] Jonathan Peterson, *Critics Fear SEC Chief Is Seeking to Limit Investors' Ability to Sue*, Los Angeles Times, Feb. 20, 2007, at C1 (quoting Amy Borrus, deputy director of the Council of Institutional Investors).

as a driving force behind recent mega-settlements.[26] NERA Economic Consulting agreed, concluding that:

> Changes in investor losses over time are sufficient to explain both the headline settlements of recent years and the trends in median settlements. That is, while average settlements have been rising, *there is no statistical evidence* that this is the result of a more difficult litigation environment for defendants.[27]

Reports of the death of this nation's global financial leadership have been greatly exaggerated. Researchers at Goldman Sachs recently criticized two studies purporting to show that "legal and regulatory practices" such as "the risk and unpredictability of litigation" in the United States would drive business away from Wall Street. In a February 2007 issue of *Global Economics Weekly*, the researchers retorted that "we do not see [such factors] as the critical drivers behind the shift in financial market intermediation, even in the aggregate. Quite simply, economic and geographic factors matter more."[28] Nor, as has been asserted, is the United States losing out in the IPO market, for according to a recent study "evidence [] clearly illustrates . . . the US market remains an

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[26] *2004 Security Litigation Study*, PricewaterhouseCoopers LLP (2005), http://www.pwc.com/extweb/pwc.publications.nsf/ docid/8bdF8eF42b852570180074F891 ("PWC 2004 Study") at 8.

[27] NERA 2006 Study at 8; *see also* Laura E. Simmons & Ellen M. Ryan, *Post-Reform Act Securities Settlements—2005 Review and Analysis*, Cornerstone Research (2006), http://securities.cornerstone.com/pdfs/settlements_2005.pdf at 2 ("In spite of the increase [in average settlement size] in 2005, it is noteworthy that the median settlement amount still remains less than $10 million."); *id.* at 4 ("The discrepancy between the magnitude of the median and average statistics arises from a small number of cases for which 'estimated damages' are quite large. There were twelve settlements in 2005 with 'estimated damages' over $5 billion.").

[28] Goldman Sachs Economic Research, *Is Wall Street Doomed?*, Global Economics Weekly, Feb. 14, 2007, at 2.

inviting locale for IPOs by both domestic and foreign issuers."[29]

Finally, to enact Petitioners' revised pleading standard would curtail or eliminate the public good—in the form of low-cost disincentives to fraud—that large institutional investors deliver when they aggressively litigate fraud claims. The Reform Act sought to enable large institutions to gain lead plaintiff status more easily, and it worked: "The rate of cases filed by public or institutional funds has grown significantly since 1996."[30] The theory underlying this policy change—that large institutional holders can more effectively prevent securities litigation abuses—has also panned out: law professor Michael A. Perino has found that cases led by public pension funds "have greater attorney effort[] and have lower fee requests and awards than cases with other types of lead plaintiffs," suggesting "that public pensions do in fact act as effective monitors of class counsel."[31]

These lead plaintiffs—"a more knowing and demanding kind of plaintiff"[32]—are sophisticated, have huge investment portfolios, and suffer large losses when defrauded. As experienced fiduciaries, they have distinguished boards that are advised by independent counsel. Contrary to Petitioners' and

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[29] *Making It in the USA: Foreign IPO Issuers Continue to Flock to US-Based Exchanges*, Lab Thomson (Jan. 30, 2007) (on file with counsel).

[30] PWC 2004 Study at 15; *see also* 141 Cong. Rec. H 13691, at *13699 (expressing Congress's clear intent that institutional investors take a more active role in securities class action suits, "to return the securities litigation system to [its prior] high standard").

[31] Michael A. Perino, *Institutional Activism through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions*, St. John's University Legal Studies Research Paper No. 06-0055, at 1 (Oct. 2006), http://ssrn.com/abstract=938722.

[32] *Classier Actions*, The Economist, Feb. 17, 2007 ("Securities Lawsuits . . . [s]hareholder class actions are fewer in number, but bigger and better led[.]").

their *amicis*' carping, these lead plaintiffs are not "professional plaintiffs,"[33] nor do they file "frivolous" suits. Rather, when institutional investors lead cases, they return substantial value to shareholders,[34] creating a powerful incentive for corporate executives to avoid lawbreaking, and enhancing honesty and accountability across the board. The successful pursuit of well-established remedies by the very institutional investors Congress sought to empower via the Reform Act does not justify a judicially liberalized dismissal standard enabling fraudulent behavior by corporations and financial interests.

In denying some of the motions to dismiss in *Enron*, Judge Melinda Harmon put the issue before the Court in perspective. Echoing Fifth Circuit Judge Robert Parker, Judge Harmon described the Reform Act as "'a mechanism for winnowing out suits that lack a requisite level of specificity,'" but added that the Act "'was not meant to let business and management run amuck to the detriment of shareholders.'" *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235

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[33] In fact, the Reform Act included a provision that *eliminated* "professional" plaintiffs by limiting the number of class action suits an investor could lead in any five-year period. 15 U.S.C. §78u-4(a)(3)(B)(vi); *see also* H.R. Conf. Rep. No. 104-369, at 35 ("Institutional investors . . . do not represent the type of professional plaintiff [the Reform Act] seeks to restrict.").

[34] PWC 2004 Study at 7 (citing "the role of public retirement fund and pension fund fiduciaries and institutional entities as 'lead plaintiffs' in class actions" as among the factors causing increased settlements); *see 2005 Securities Litigation Study*, PWC Advisory (2005), http://www.pwc.com/extweb/service.nsf/docid/6F1068F6F245D6D1802572260047212/$file/study_%20seclit.pdf, at 17 ("Such huge settlements can be associated with several factors: . . . the role of lead plaintiffs (many of which are now . . . institutions such as pension funds . . . .")); *see also* NERA 2006 Study at 9 ("Cases with an institutional investor acting as lead plaintiff settle for approximately one-third more on average. It is impossible to judge whether this correlation reflects the actions of the lead plaintiff, or the nature of the cases in which institutions choose to be lead plaintiffs.").

F. Supp. 2d 549, 593 (S.D. Tex. 2002). Rather, Judge Harmon warned:

> The PSLRA's significance as a protective shield for business must be viewed within the context of the private right of action, granted decades before, to defrauded investors injured by corporate management, auditors, outside counsel, and investment bankers where their conduct allegedly violated the federal securities laws. . . . *The importance of this tool has been highlighted by recent disclosures of extraordinary corporate misconduct.*

Id. at 593-94.

In *Enron*, injured shareholders have thus far achieved a $7.3 billion recovery, the largest in history. Most of that recovery has come from major banks implicated in the *Enron* fraud. Despite the unimpeachable evidence of corporate fraud at Enron, however, it is not clear that the *Enron* lead plaintiff could have either pleaded a "high likelihood" of scienter by the bank defendants, or survived those defendants' "non-culpable explanations" and "innocent inferences." If not, the victims of that unprecedented fraud would have recovered little.

Such a system, sought now by Petitioners, would create disincentives for honest behavior by corporate executives and their accountants, lawyers, and bankers, and would undermine investor confidence as well as our citizens' faith in our legal system.

II. THE SEC IS NOT ENTITLED TO DEFERENCE IN THIS CASE BECAUSE IT IS ADDRESSING A MATTER OUTSIDE ITS PRIMARY JURISDICTION AND HAS CHANGED ITS POSITION

The views of an administrative agency are entitled to deference only where they reflect a "consistent, longstanding interpretation" of its statute. *Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 556 n.20 (1979). Here, the SEC opines on an issue not within its particular expertise and with a view that directly contradicts the position it otherwise has uniformly taken since the passage of the Reform Act. Moreover, it has done so without either acknowledging its prior position or explaining the rationale for its about-face. Consequently, its "new" position warrants no deference.[35]

The issue presented in this case is not within the SEC's primary jurisdiction or expertise. Rather, it involves a matter of pleading and practice controlled by the Federal Rules of Civil Procedure and a provision of the Reform Act addressed to *private* securities litigation.[36] On this matter, then, the SEC has no special standing and its views are not entitled to

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[35] *See AFSCME v. Am. Int'l Group, Inc.*, 462 F.3d 121, 126-30 (2d Cir. 2006) (rejecting the SEC's interpretation of one of its own regulations because it was inconsistent with the position the SEC had taken for 16 years, noting: "In its amicus submission, the SEC fails to so much as acknowledge a changed position, let alone offer a reasoned analysis of the change."); *In re Enter. Mortgage Acceptance Co., LLC Sec. Litig.*, 391 F.3d 401, 410 (2d Cir. 2004) (deference to SEC's views on Sarbanes-Oxley "would [] be inappropriate because the SEC's area of expertise does not afford it particular insight"); *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 42 n.27 (1977) ("Even if the agency spoke with a consistent voice, however, its presumed 'expertise' in the securities-law field is of limited value when the narrow legal issue is one peculiarly reserved for judicial resolution . . . .").

[36] The Reform Act's heightened pleading requirements affect only "private actions" and not those brought by the SEC. *SEC v. Prater*, 296 F. Supp. 2d 210, 215-16 (D. Conn. 2003).

more weight than any other litigant. *E.g.*, *Enter. Mortgage*, 391 F.3d at 410.

The Court has in fact rejected the SEC's views in several private action cases:

- *Lampf*, 501 U.S. at 352-61 (rejecting the SEC's position that a five-year statute of limitations should be applied to §10(b) actions);
- *Cent. Bank*, 511 U.S. at 176-78 (rejecting the SEC's position that §10(b) created aiding and abetting liability);
- *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 94 (1987) (rejecting the SEC's position that the Williams Act preempted an Indiana state law); and
- *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199, 214 n.33 (1976) (rejecting the SEC's attempt to "add a gloss to the operative language of the statute" and refusing to "examine the additional considerations of 'policy' [the SEC argued] may have influenced the lawmakers in their formulation of the statute").

Moreover, the position taken by the SEC here is inconsistent with a position it has uniformly and repeatedly presented to Congress and the courts in the past. *AFSCME*, 462 F.3d at 129 ("In its amicus submission, the SEC fails to so much as acknowledge a changed position, let alone offer a reasoned analysis of the change."). In testimony presented to the House in 1995, for example, the SEC *opposed* efforts to require plaintiffs to "establish" scienter and, in particular, to impose a test "more stringent than the Second Circuit test." 104 H. Rpt. 050 at "H.R. 10's Harsh Pleading Requirements are Unattainable."

> There is a significant difference between having to allege facts that give rise to a "strong inference" that the defendant acted knowingly or recklessly, and having to plead facts that "establish" that the defendant had the

> requisite state of mind. *We believe that it is inappropriate to establish any test more stringent than the Second Circuit test*, which many experts already believe is already too severe.
>
> Because we believe that the bill as reported may result in meritorious fraud cases being dismissed, we are unable to support this provision.

Id.[37] The SEC's opposition was heeded by legislators. *See* S. Rep. No. 104-98, at 15 (1995), *reprinted in* U.S.C.C.A.N. 679, 694 ("the Committee chose a uniform standard modeled upon the pleading standard of the Second Circuit"); 141 Cong. Rec. S 17,969 (1995) (Domenici) ("the conference report adopts the pleading standard utilized by the second circuit court of appeals"); *id.* at S 17,959 (Dodd), S17,934 (D'Amato), S 17,993 (Grams).

The Appendix collects excerpts from the numerous *amicus* briefs in which the SEC has repeatedly taken the position that the Reform Act adopted the Second Circuit test. In none of those statements does the SEC suggest that the test requires plaintiffs to plead facts that establish a "high likelihood" of scienter, or requires a court to weigh "non-culpable explanations" or "innocent inferences" against inferences drawn from the complaint. *See* Appendix at 1a-3a. The statements in the SEC's *Green Tree amicus* brief, excerpted at Appendix 4a-11a, are typical:

> The Reform Act uses the term "strong inference," which was developed as a scienter pleading standard in Second Circuit decisions . . . . It may be presumed, absent contrary evidence, that Congress intended to adopt the judicial definition of that well-established pleading standard. . . .

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[37] Although the House adopted HR 1058 which included the "establish scienter" requirement, H.R.1058—Securities Litigation Reform Act, 141 Cong. Rec. H2760, at *2769, that formulation was absent from the final bill.

> That standard is satisfied by strong circumstantial evidence of conscious misbehavior or recklessness . . . . A strong inference of scienter can also be shown by alleging motive and opportunity to commit fraud. These Second Circuit tests are proven, sound, widely used, and consistent with the Reform Act's purposes. Nothing in the Act shows that the Act deviates from these established means of pleading a "strong inference."
>
> * * *
>
> Congress calibrated the Act's pleading standards to balance multiple concerns. Congress sought to weed out meritless claims at an early stage, but it also wanted meritorious claims to proceed. . . .
>
> The Second Circuit's tests strike the right balance and provide a basis for uniformity. . . . At the same time, the Second Circuit tests are exacting. . . . [T]he Second Circuit's tests for showing a "strong inference" of scienter are proven, sound, widely used, and consistent with the Act's language and purposes.[38]

The SEC also has explained that the Securities Litigation Uniform Standards Act of 1998 ("Standards Act") reaffirmed Congress's adoption of the Second Circuit standard:

> In deciding whether to enact the Standards Act, it was crucial that Congress understand what the key provisions of the Reform Act meant, because the preemption of state law would make those provisions applicable to all of the covered class action suits. . . . The [Conference Committee] Statement also made clear that (*id.*):
>
> > the Reform Act establish[ed] a heightened uniform Federal standard on pleading requirements based upon

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[38] *See* Brief of the Securities and Exchange Commission as *Amicus Curiae* in Support of Appellant on the Issues Specified, *Fla. St. Bd. of Admin. v. Green Tree Fin. Corp.*, No. 99-3563 (8th Cir. Dec. 21, 1999) (excerpts at Appendix 4a-13a).

> the pleading standard applied by the Second Circuit Court of Appeals. . . .
>
> [1998 Conf. Rep. at 15.] The President shared the Conference Committee's view. His staff, along with the Commission, participated in shaping the legislation, and the assurances in the legislative history that the Reform Act did not alter the existing law on scienter were essential to the President's support of the bill in Congress. *See* 144 Cong. Rec. H10, 784-85, S12,445, S12,449-50 (1998). When the President signed the Standards Act, he emphasized that he agreed with the Commission's views on . . . the Second Circuit pleading standard, and that he was signing the Standards Act based on that understanding. *See* Statement of the President on Uniform Standards Act (Nov. 3, 1998).

Green Tree amicus, Appendix 12a-13a; *see Seatrain Shipbuilding Corp. v. Shell Oil Co.*, 444 U.S. 572, 596 (1980) ("views of subsequent Congresses . . . are entitled to significant weight").

Now, for the first time, and without acknowledging its previous statements, the SEC says that the "strong inference" standard requires courts to go *beyond* the complaint and plaintiff's allegations and weigh "the relative strength" of the inferences drawn from the complaint against those asserted by defendant. SEC Amicus Brief at 9, 25-26.[39]

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[39] The SEC urges imposing on private litigants a rule it would not have to comply with. In contrast to actions brought by private plaintiffs, the SEC asserts that the following test should be applied when it sues under §10(b) on its own authority:

> The reviewing court accepts as true the well-pleaded factual allegations of the complaint, draws all reasonable inferences in the plaintiff's favor, and determines whether the complaint, so read, sets forth facts sufficient to justify judgment for the plaintiff on any applicable legal theory.

This about-face is not entitled to deference. As Justice Powell noted in *Int'l Bhd. of Teamsters*, 439 U.S. at 566-67, "the SEC's position [is not] longstanding," and it has taken a "different position" than it had "repeatedly" taken in *amicus* briefs and Congressional testimony. Thus, where "the SEC's present position [was] flatly contradicted by its past actions," its new desires should yield to the "clear meaning of a statute, as revealed by its language, purpose, and history." *Id.* at 566; *see also United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 858 n.25 (1975) ("The SEC's position flatly contradicts what appears to be a rather careful statement of the Commission's views .... In view of this unexplained contradiction in the Commission's position we accord no special weight to its views.").[40]

SEC v. Rocklage, No. 06-1571, *Brief of the Securities and Exchange Commission, Appellee*, at 10 (1st Cir. June 2006), http://www.sec.gov/litigation/appellatebriefs.shtml. The SEC argues its factual allegations created "reasonable inferences" that defendants had the requisite scienter. *Id.* at 11, 13. In *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006), the Court of Appeal applied the dismissal standard the SEC asserted and affirmed the district court's denial of defendants' motion to dismiss. *Id.* at 3.

[40] The SEC claims that the Reform Act was "intend[ed] to *strengthen* existing pleading requirements" and was "not intend[ed] to codify the Second Circuit's case law interpreting [its] pleading standard." SEC Amicus Brief at 18. The Reform Act clearly strengthen the existing pleading standards, not by changing the Second Circuit "strong inference" standard as the Government suggests, but by including various specific requirements in the statute itself. As the Conference Committee explained: "The reason or reasons why the statement is misleading must also be set forth in the compliant [sic] in detail. If an allegation is made on information and belief, the plaintiff must state with particularity all facts in the plaintiff's possession on which the belief is formed." H.R. Conf. Rep. No. 104-369, at 41.

III. CHANGING DISMISSAL RULES TO REQUIRE THE WEIGHING OF "INNOCENT INFERENCES" AND "NON-CULPABLE EXPLANATIONS" WILL CREATE UNCERTAINTY AND CONFLICTING RESULTS IN §10(b) LITIGATION

Rule 12(b)(6)'s procedural matrix—that well-pleaded allegations are accepted as true, and plaintiffs are given the benefit of reasonable inferences—is a tried-and-true one. Courts have decades of experience applying it. A new pleading procedure not only will unsettle matters with respect to §10(b) cases, but also will encourage similar modifications of Rule 12(b)(6) for other cases with elevated pleading or proof standards.

Moreover, new dismissal procedures for securities cases, if deemed retroactive, will cause reexamination of scores of previously denied motions to dismiss in pending actions. Because these cases are now in discovery, reopening those motions will create a conflict: Plaintiffs will understandably attempt to utilize existing discovery in amendments to meet any newly heightened standards—and defendants will oppose them. Resolving such revisited motions could consume judicial resources for years.

At bottom, because the Reform Act's heightened pleading standard was intended to create pleading uniformity, it makes little sense now to introduce notions of "innocent inferences" and "non-culpable explanations"—factual denials and favorable spins—which will necessarily depend upon defendants' subjective states of mind and their evaluation at the pleading stage.[41] If judges are required to weigh "non-culpable

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[41] For instance, defendants will argue that it is irrational for a CEO to lie because if the fraud unravels, private, SEC, or DOJ suits—even CEO ouster—will follow, all carrying economic risk and reputational harm. This creates, they will argue, a compelling incentive to comply with the

explanations" and "innocent inference" arguments, factual assertions not subject to Rule 11 will be introduced into the dismissal equation. But those subjective assertions cannot be properly weighed at the pleading stage; there exists no objective standard to determine their veracity or weight. Precedents will become more confused and outcomes less predictable—an outcome that this Court abhors. *See Central Bank v. First Interstate Bank*, 511 U.S. 164, 188-191 (1994) (rejecting aiding and abetting liability in §10(b) cases as "the rules for determining aiding and abetting liability *are unclear* in 'an area that demands *certainty and predictability*,'" and it would lead to "the undesirable result of decisions '*made on an ad hoc basis, offering little predictive value*'" and "*would work a significant shift in settled interpretive principles*").[42]

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law which outweighs any inferences of motive or opportunity to commit fraud. CEOs will further argue that they were only overly optimistic in making the challenged statements, and that it is important for executives to be optimistic about solving the problems they encounter, and that because they were successful in overcoming prior challenges, they expected to overcome the problems at hand. They will argue suspicious-appearing stock sales were made only because of pending expiration of options, personal financial reversals, financial emergencies, or a desire to diversify holdings in anticipation of retirement—not trading on inside information. They will argue that they were unaware of problems, as they were too busy to look into the goings-on in the bowels of the company and relied on representations of regularity—false it turns out—of underlings. They will claim any misaccounting was beyond their expertise and in the domain of others, with the company's "numbers" having been approved by accountants, not them. None of these and many other potential assertions can be reliably weighed at the pleading stage. All involve factual issues that must be tested through the established process under appropriate judicial oversight.

[42] In short, what the corporate community seeks is a new set of barriers and discriminatory dismissal rules beyond what Congress enacted in 1995. This issue is properly for Congress not the Court.

CONCLUSION

The Court should achieve the uniformity Congress intended by ruling that the Reform Act adopted the Second Circuit's "strong inference" scienter pleading standard, and that this standard does not require considering "competing" or "innocent inferences" or "non-culpable explanations" or establishing a "high likelihood" of scienter. The case should be remanded for a determination whether the complaint satisfies (or can satisfy) that standard.

Respectfully submitted,

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APPENDIX

APPENDIX

Securities and Exchange Commission's Formerly Consistent Position on the Reform Act's Heightened Pleading Standards

"Congress ***explicitly adopted the Second Circuit's formulation for pleading scienter when it enacted the Reform Act***. Courts construing the Reform Act should apply that standard by using the proven tests that the Second Circuit has developed in the course of deciding many cases."

> *Zeid v. Kimberley*, Brief of the Securities and Exchange Commission, Amicus Curiae, No. 97-16070, 1997 WL 33555504 (9th Cir. Oct. 30, 1997);
>
> *See also In re Silicon Graphics Sec. Litig.*, Brief of the Securities and Exchange Commission, Amicus Curiae, No. 97-16240, 1997 WL 33551249, at *16 (9th Cir. Nov. 1997) ("Congress intended that courts would rely on the the Second Circuit tests in interpreting the pleading standard of the Reform Act.");
>
> *See also In re Comshare, Inc. Sec. Litig.* Brief of the Securities and Exchange Commission, Amicus Curiae, No. 97-2098, 1997 WL 34039763, at *14 (6th Cir. Nov. 1997) ("The language and legislative history of the Reform Act leave no doubt that Congress adopted the Second Circuit's 'strong inference' formulation for pleading the Reform Act's 'required state of mind.'").

"It may be presumed from the Reform Act's 'strong inference' language, absent contrary evidence, that Congress intended to adopt the judicial definition of the well-established Second Circuit pleading standard, including its 'motive and opportunity' and 'strong circumstantial evidence' analytical tests."

Nathenson v. Zonagen, Brief of the Securities and Exchange Commission, Amicus Curiae, No. 99-20449, 1999 WL 33613893, at *12 (5th Cir. Sept. 30, 1999);

See also Bryant v. Avado Brands, Inc., Brief of the Securities and Exchange Commission, Amicus Curiae, No. 98-9253, 1999 WL 33631523, at *10 (11th Cir. Feb. 16, 1999).

"It may be presumed from the [95] Act's 'strong inference' language, absent contrary evidence, that Congress intended to adopt the judicial definition of the well-established Second Circuit pleading standard, including its [two] analytical tests."

* * * *

"***The Second Circuit's tests strike the right balance and provide a basis for uniformity.*** As explained in *Press*, 166 F. 3d at 538, the Second Circuit 'has resisted accepting general allegations of scienter' while declining 'to create a nearly impossible pleading standard when the "intent" of a corporation is at issue.'"

Fla. St. Bd. of Admin. v. Green Tree Fin. Corp., Brief of the Securities and Exchange Commission as Amicus Curiae in Support of Appellants on the Issues Specified, No. 99-3536 (8th Cir. Dec. 21, 1999) at pp. 8a-10a (excerpts attached hereto);

See also Weld v. Stage Stores, Inc., Brief of the Securities and Exchange Commission, Amicus Curiae, No. 00-20230, 2000 WL 34032458, at *5-*6 (5th Cir. June 23, 2000) ("These Second Circuit tests are proven, sound, widely used, and consistent with the Reform Act's purposes. Nothing in the Act deviates from these established means of pleading a 'strong inference.'");

See also In re K-Tel Int'l Inc. Sec. Litig., Brief of the Securities and Exchange Commission, Amicus Curiae, No. 003210, 2000 WL 35483737, at *1 (8th Cir. Nov. 15, 2000) ("The 'strong inference' pleading standard was developed in a long line of cases by the Second Circuit.");

See also Caprin v. Simon Trans. Serv., Brief of the Securities and Exchange Commission, Amicus Curiae, No. 01-4049, 2001 WL 34664973, at *1 (10th Cir. July 2, 2001).

"It is the Commission's view that the Reform Act's scienter pleading provision . . . adopts the Second Circuit standard for pleading scienter in a private action . . . . ***The Commission has expressed this view in amicus curiae briefs filed over the past 18 months in five other pending appeals raising the issue of the Reform Act's scienter pleading standard.***" [citing above amicus]

* * * *

"***The Commission believes . . . that it would be useful for the Court to have available to it the Commission's views on the important issue of the interpretation of the Reform Act's scienter pleading provision***. . . . We are, accordingly, submitting . . . a copy of the Commission's brief in *Bryant v. Apple South, Inc* . . . ."

Greebel v. FTP Software, Inc., Brief of the Securities and Exchange Commission, Amicus Curiae, No. 98-2194, 1999 WL 33911562, at *2-*5 (1st Cir. May 27, 1999).

* * * *

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 99-3536

FLORIDA STATE BOARD OF ADMINISTRATION,
Plaintiff/Appellant.

v.

GREEN TREE FINANCIAL CORPORATION; LAWRENCE M. COSS; ROBERT D. POTTS; EDWARD L. FINN,
Defendants/Appellees.

On Appeal from the United States
District Court for the District of Minnesota

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION AS *AMICUS CURIAE* IN SUPPORT OF APPELLANT ON THE ISSUES SPECIFIED

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the courts to adopt those tests, under which "motive and opportunity" and "strong circumstantial evidence" are sufficient to plead scienter.

STATEMENT OF ISSUES

1. Whether the Reform Act's state of mind pleading provision alters the well-established law of this and every other circuit to have considered the issue that recklessness is sufficient to satisfy the state of mind requirement under Section 10(b) and Rule 10b-5.

2. Whether the Reform Act heightens the rigorous standard for pleading a "strong inference" of scienter that was developed in a long line of Second Circuit decisions and followed by many district courts in this Circuit in pre-Act cases, under which a private plaintiff may allege either (a) facts to show that the defendant had both a motive and an opportunity to commit fraud or (b) facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.

SUMMARY OF ARGUMENT

The Reform Act requires that private plaintiffs "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind," but does not define that state of mind. The "required state of mind" language thus leaves untouched the well-established body of law in this and other courts that recklessness suffices to establish scienter under Section 10(b) and Rule 10b-5. Where the Reform Act modifies or eliminates the existing recklessness standard, it does so expressly. To date, at least five courts of appeals have concluded that the Reform Act's scienter pleading standard does not affect recklessness as a basis for liability.

The Reform Act uses the term "strong inference," which was developed as a scienter pleading standard in Second

Circuit decisions that many district courts in this Circuit have followed. It may be presumed, absent contrary evidence, that Congress intended to adopt the judicial definition of that well-established pleading standard. To date, at least two courts of appeals and the majority of district courts have so concluded.

That standard is satisfied by strong circumstantial evidence of conscious misbehavior or recklessness, and thus is consistent with pleading and proving recklessness. A strong inference of scienter can also be shown by alleging motive and opportunity to commit fraud. These Second Circuit tests are proven, sound, widely used, and consistent with the Reform Act's purposes. Nothing in the Act shows that the Act deviates from these established means of pleading a "strong inference."

Moreover, authoritative legislative history of the Reform Act and of the related, recently enacted Securities Litigation Uniform Standards Act of 1998 ("Standards Act"), Pub. L. No. 105-353, 112 Stat. 3227, confirms that in using the "strong inference" language Congress adopted the Second Circuit pleading standard. In fact, when the President vetoed the 1995 bill over concerns that that standard had not been adopted, the bill's managers, in the debate leading to an override of the veto, made clear their endorsement of that standard.

ARGUMENT

I. THE REFORM ACT'S STATE OF MIND PLEADING PROVISION DOES NOT DISPLACE THE LONG-STANDING JUDICIAL RULE THAT RECKLESSNESS SUFFICES TO SHOW SCIENTER UNDER SECTION 10(b) OF THE EXCHANGE ACT AND RULE 10b-5 THEREUNDER.

The Reform Act's state of mind pleading provision does not change the well-settled law in this and all other circuits that have considered the issue that the required state of mind

under Section 10(b) and Rule 10b-5 encompasses recklessness. At least five courts of appeals have reached this conclusion. *See Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198-201 (1st Cir. 1999); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1281-84 (11th Cir. 1999); *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 548-51 (6th Cir. 1999); *Advanta*, 180 F.3d at 534-35; *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 537-38 (2d Cir. 1999);

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The Commission agrees. It also believes that elimination of recklessness liability would encourage corporate directors and officers to put their heads in the sand and would have enormously counterproductive effects on the integrity of corporate disclosure and the quality of corporate governance.

II. THE REFORM ACT ADOPTS, OR AT LEAST LEAVES IT TO THE COURTS TO ADOPT, THE SECOND CIRCUIT'S TESTS, UNDER WHICH "MOTIVE AND OPPORTUNITY" AND "STRONG CIRCUMSTANTIAL EVIDENCE" ARE SUFFICIENT TO PLEAD SCIENTER.

The Reform Act adopts the "strong inference" standard for pleading state of mind in private securities actions. 15 U.S.C. 78u-4(b)(2). The Second Circuit created the "strong inference" standard, and, in a long line of decisions, developed analytical tests for applying it. *See, e.g., Shields*, 25 F.3d at 1128 (citing cases); *Goldman v. Belden*, 754 F.2d 1059, 1070 (2d Cir. 1985). In the Second Circuit, a plaintiff could either "(a) allege facts to show that 'defendants had both motive and opportunity to commit fraud' or (b) allege facts that 'constitute strong circumstantial evidence of conscious misbehavior or recklessness.'" *E.g., Press*, 166 F.3d at 538. In pre-Reform Act cases, many district courts in this Circuit followed the Second Circuit's approach. *See* n.2, *supra*. There is no reason to reject that approach in cases under the Act.

As at least two courts of appeals and the majority of district courts have determined, the Reform Act's pleading standard does not reject recklessness or motive and opportunity as bases for pleading scienter. *See, e.g., Advanta*, 180 F.3d at 534-35 ("we hold that it remains sufficient [under the Act] for plaintiffs to plead scienter by alleging facts 'establishing a motive and an opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior'"); *Press*, 166 F.3d at 537-38; *In re Transcrypt Int'l Sec. Litig.*, No. 4:98CV3099, 1999 U.S. Dist. LEXIS 17540, at *23-24 (D. Nebr. Nov. 4, 1999); *Schlagel v. Learning Tree Int'l*, No. CV 98-6384 ABC(Ex), 1998 U.S. Dist. LEXIS 20306, at *41-48 (C.D. Cal. Dec. 29, 1998); *see also Comshare*, 183 F.3d at 551 (under Act, plaintiffs may plead recklessness, and "facts regarding motive and opportunity * * * may, on occasion, rise to the level of creating a strong inference of reckless or knowing conduct"); *Bryant*, 187 F.3d at 1283 ("we are in basic agreement with [*Comshare*]"); *Greebel*, 194 F.3d at 197 (permitting, in addition to pleading of recklessness, "use of motive and opportunity type pleading if it raises a strong inference"). Rather, the Reform Act adopts or leaves it to the courts to adopt the "motive and opportunity" and "strong circumstantial evidence" tests.

It may be presumed from the Act's "strong inference" language, absent contrary evidence, that Congress intended to adopt the judicial definition of the well-established Second Circuit pleading standard, including its "motive and opportunity" and "strong circumstantial evidence" analytical tests. *See Advanta*, 180 F.3d at 534 ("Congress's use of the Second Circuit's language compels the conclusion that the Reform Act establishes a pleading standard approximately equal in

stringency to that of the Second Circuit"); *Press*, 166 F.3d at 537.[7]

At a minimum, however, the Reform Act leaves it to the courts to decide whether to adopt those analytical tests, which many district courts in this Circuit did in pre-Act cases. As the body of precedent applying the Second Circuit standard shows, pleading strong circumstantial evidence of recklessness or pleading motive and opportunity is clearly consistent with pleading a "strong inference" of scienter, the language used in the Reform Act. Moreover, the Second Circuit's tests are consistent with the Act's purposes.

Congress calibrated the Act's pleading standards to balance multiple concerns. Congress sought to weed out meritless claims at an early stage, but it also wanted meritorious claims to proceed. *See* Joint Explanatory Statement of the Committee of Conference ("Statement of Managers"), Conference Report on Securities Litigation Reform, H.R. Conf. Rep. No. 104-369, at 31 (1995) ("1995 Conf. Rep."). Furthermore, Congress was concerned that "courts of appeals have interpreted Rule 9(b)'s requirement in conflicting ways, creating distinctly different pleading standards among the circuits," and sought to create a "uniform" national pleading standard, *id.* at 41, not "a new and untested pleading standard that would generate additional litigation," S. Rep. No. 104-98, at 15 (1995).

The Second Circuit's tests strike the right balance and provide a basis for uniformity. As explained in *Press*, 166 F.3d at 538, the Second Circuit "has resisted accepting gen-

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[7] *See generally Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554, 562 (1991) ("Because these decisions were part of the 'contemporary legal context' in which Congress enacted [the statute] * * * we may presume that Congress intended to codify these principles"); *Lorillard v. Pons*, 434 U.S. 575, 581 (1978). As discussed in Argument III, the presumption that Congress intended to adopt the Second Circuit standard is supported, not overcome, by the legislative history.

eral allegations of scienter" while declining "to create a nearly impossible pleading standard when the 'intent' of a corporation is at issue." The motive and opportunity test applies where fraud is most likely to have occurred, such as where the misrepresentation was allegedly made to induce an investment, or where inflation of revenues is accompanied by unusual, large-scale insider trading. *See Cohen v. Koenig*, 25 F.3d 1168, 1174 (2d Cir. 1994); *Rubinstein v. Collins*, 20 F.3d 160, 169-70 (5th Cir. 1994). It serves an important function by allowing the most credible claims of fraud to proceed.

At the same time, the Second Circuit tests are exacting. *See Advanta*, 180 F.3d at 534 ("the most restrictive prior to the Reform Act"); *Comshare*, 183 F.3d at 549 ("the most stringent test"); *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 979 (9th Cir. 1999) ("the most stringent existing standard"); *Stevelman v. Alias Research Inc.*, 174 F.3d 79, 84-86 (2d Cir. 1999) (stringently applying tests); *Phillips*, 190 F.3d at 621-24 (same). Conclusory allegations that defendants were attempting to inflate the stock price because they held shares in the company, to boost their compensation, or to retain their positions, do not suffice to plead motive. *See, e.g., Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995); *Shields*, 25 F.3d at 1130; *Melder v. Morris*, 27 F.3d 1097, 1102 (5th Cir. 1994). Nor do allegations that auditors were motivated to conduct a fraudulent audit to secure fees. *See, e.g., Melder*, 27 F.3d at 1103.

Rather, as a leading Second Circuit case held, the plaintiff must plead a motive consistent with "informed economic self-interest" and an opportunity to "achiev[e] concrete benefits by the means alleged." *Shields*, 25 F.3d at 1130. And where motive is not apparent, "the strength of the circumstantial allegations must be correspondingly greater." *Tuchman v. DSC Comm. Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994) (citing *Beck v. Manufacturers Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987)). Thus, the Second Circuit's tests for show-

ing a "strong inference" of scienter are proven, sound, widely used, and consistent with the Act's language and purposes.

Although the courts of appeals have been unanimous in holding that strong circumstantial evidence of recklessness (in at least some form, *see* pp. 6-7, *supra*) can give rise to a "strong inference" of scienter under the Reform Act, they appear to be divided on the role of allegations of motive and opportunity. The Commission believes that the reason is that courts have characterized the motive and opportunity test in different ways.

Courts that are not familiar with the test, and have seemed to limit use of motive and opportunity allegations under the Reform Act, have mistakenly suggested that the test can be satisfied by general averrals of "motive and opportunity." *See Silicon Graphics*, 183 F.3d at 979 (suggesting that test allows plaintiffs to "aver intent in general terms of mere 'motive and opportunity'"); *Greebel*, 194 F.3d at 197 ("merely pleading motive and opportunity, regardless of the strength of the inferences to be drawn of scienter"); *Bryant*, 187 F.3d at 1286 ("'bare allegations of motive and opportunity'"); *Comshare*, 183 F.3d at 551 ("bare pleading of motive and opportunity").

Courts that have applied the test in the past, and held that it satisfies the Reform Act, however, have indicated that this is incorrect. *See Press*, 166 F.3d at 538 (Second Circuit "has resisted accepting general allegations of scienter that would lead to the presumption of motive for any publicly-held corporation that 'desires its stock to be priced highly by the market'"); *Advanta*, 180 F.3d at 535 (adopting same pleading standard as *Press*); *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1423 n.12 (3d Cir. 1997) (stringently applying motive and opportunity test); *Shields*, 25 F.3d at 1130 (same). And the Reform Act makes clear that plaintiffs must state facts constituting a strong inference of the required state of mind "with particularity." *See Advanta*, 180 F.3d at 534.

In the Commission's view, allegations that satisfy a motive and opportunity test applied with the proper rigor and analytical precision give rise to a strong inference of scienter.[8]

* * * *

In deciding whether to enact the Standards Act, it was crucial that Congress understand what the key provisions of the Reform Act meant, because the preemption of state law would make those provisions applicable to all of the covered class action suits. Congress believed that it was particularly important to make clear that the Reform Act did not in any way change the existing law on scienter under Section 10(b) and Rule 10b-5 (*i.e.*, that recklessness is sufficient).

The Statement of Managers of the Standards Act explicitly and unambiguously states in this regard:

> It is the clear understanding of the managers that Congress did not, in adopting the Reform Act, intend to alter the standards of liability under the Exchange Act.
>
> The managers understand, however, that certain Federal district courts have interpreted the Reform Act as having altered the scienter requirement. In that regard, the managers again emphasize that the clear intent in 1995 and our continuing intent in this legislation is that neither the Reform Act nor [the Standards Act] in any way alters the scienter standard in Federal securities fraud suits.

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[8] The First Circuit offers no basis for its suggestion in *Greebel*, 194 F.3d at 196, that the Second Circuit tests would impede a court in "analyz[ing] the particular facts alleged in each individual case" or in developing and using "fact-specific inquir[ies]." Its statement, *id.* at 197 (quoting *Comshare*), that facts regarding motive and opportunity are proof of scienter, not "scienter itself," is beside the point; it is the Reform Act's "strong inference" language, not its "required state of mind" language, that refers to the Second Circuit scienter pleading standard.

1998 Conf. Rep. at 15. The Statement also made clear that (*id.*):

> the Reform Act establish[ed] a heightened uniform Federal standard on pleading requirements based upon the pleading standard applied by the Second Circuit Court of Appeals. Indeed, the express language of the Reform Act itself carefully provides that plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."

The President shared the Conference Committee's view. His staff, along with the Commission, participated in shaping the legislation, and the assurances in the legislative history that the Reform Act did not alter the existing law on scienter were essential to the President's support of the bill in Congress. *See* 144 Cong. Rec. H10,784-85, S12,445, S 12,449-50 (1998). When the President signed the Standards Act, he emphasized that he agreed with the Commission's views on both the scienter element and the Second Circuit pleading standard, and that he was signing the Standards Act based on that understanding. *See* Statement of the President on Uniform Standards Act (Nov. 3, 1998).

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